In the

Supreme Court of the United States

OCTOBER TERM, 1957

No. 108

FRANK SCOFIELD, Former Collector of Internal Revenue,
Petitioner,

v.

DENNIS M. O'CONNOR, *et al.*;
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

BRIEF FOR RESPONDENTS, DENNIS O'CONNOR, et al.

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BRIEF FOR RESPONDENTS, DENNIS O'CONNOR, et al.

OPINIONS BELOW

The findings of fact and conclusions of law of the District Court in the *O'Connor* case (R. 74-78) are reported at 143 F. Supp. 240. The opinion of the Court of Appeals (R. 80-86) is reported at 241 F. 2d 65.

JURISDICTION

The judgment of the Court of Appeals was entered on February 1, 1957. (R. 87.) The petition for a Writ of Certiorari was filed April 17, 1957, and was granted June 3, 1957. This Court has jurisdiction under 28 U. S. C., Sec. 1254.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1939, being Section 117, are set forth in Appendix A., pp. 57-61, infra.

QUESTIONS PRESENTED

Is the cash sale in this case of a limited overriding royalty subject to capital gain treatment under Section 117 of the 1939 Code where, as found by both Courts below, the sale was bona fide; had a bona fide business purpose; was not a loan or mortgage; was not an assignment or anticipation of income; but was a sale of a real and substantial interest in taxpayers' properties.

STATEMENT

On Nov. 26, 1948, the executors of the Estate of Thomas O'Connor, deceased, transferred, by general warranty deed, duly recorded in the deed records of Refugio County, Texas, the entire royalty interest of the Estate under eight designated tracts of land to one D. E. Blackburn for the cash consideration of $9,990,350. The royalty interest sold to Blackburn had been held by decedent and subsequently by

his Estate for many years. (R. 74, 75.) The deed provided that after the royalties described therein had produced for Blackburn the prescribed quantity of oil, the properties would revert to the grantors. (R. 75.) Blackburn made a substantial profit on the transaction and reported and paid tax on his profit. (R. 76.)

The sale was made for the purpose of raising funds to pay Federal estate taxes, State inheritance taxes, Federal income taxes and administration expenses of the Estate. (R. 59-60, 76.)

This was the first and only sale of any type of mineral interests that the decedent or his Estate had ever made. (R. 76.)

The oil payment "paid out" after three years of production and during the time the royalties were owned by Blackburn. The oil payment would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field because of the drilling of additional wells by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale of the oil payment, which higher price was maintained during the period of the pay-out. (R. 76.)

If the sale is entitled to capital gain treatment, the tax on the sale is a little over $2,000,000. If, however, the proceeds are taxable as ordinary income, the tax, after allowance for depletion, will amount to over $5,600,000.

Based on a stipulation of facts and the uncontradicted testimony of two witnesses, the District Court made the following findings:

Both the sellers and the buyer, Blackburn, intended the transaction in question to be a sale and purchase of the royalty interest in question. They did not intend to enter into a loan or mortgage transaction. (R. 77.)

The transaction with Blackburn was a bona fide sale. (R. 77.)

The purpose of the sale was a bona fide business purpose. (R. 77.)

The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. (R. 77.)

This property interest was substantial and real, representing a substantial part of the grantors' royalty interest. (R. 76, 77.)

The property so sold was a long-lived, and not a short-lived, oil payment. (R. 77.)

The property interest so sold to Blackburn was a capital asset as defined in Sec. 117 of the Internal Revenue Code of 1939, and this capital asset had been held by taxpayers for more than six months. (R. 77.)

The Circuit Court of Appeals, after reviewing the evidence, held that "on record made, the District Judge was right and his judgment should be affirmed." (R. 86.)

SUMMARY OF ARGUMENT

I.

A. Passing for the moment the "short-lived" oil payments, which will be discussed later, the following rules are clear:

1. The sale of a carved out oil payment is the sale of a property within the purpose as well as the letter of Section 117 (a). None of the stated exceptions are applicable. In the Committee Reports on the 1921 Act, Congress expressly stated that it intended sale of "mineral properties" to have the benefit of the lower rate. An oil payment is, without doubt, a "mineral property." Moreover, as pointed out by the Court in *Burnet v. Harmel*, 287 U. S. 103 (1932), to tax a long-lived oil payment at normal rates would produce "the kind of hardship aimed at by the capital gain provisions of the taxing act." The Government concedes that an oil payment per se is a capital asset; but its position is that Congress intended to give a different treatment to an oil payment carved out of a larger interest. The retention of a reversionary interest is said to convert what is otherwise admittedly a capital asset into an assignment of income.

2. The sale of a carved out oil payment is not an assignment of future income. It is utterly unlike a prepayment of rent or an advance sale of derivative income. It is not the sale of the fruits of a tree, but a sale of a large part of the tree itself. It is a bulk sale of a large number of barrels in place. It is not the temporary assignment of the fruits of property. It is the sale of a large number of the economic

units in place which are extracted and consumed by the new owner, which property the seller never regains on termination of the interest sold.

The sale of an oil payment is an anticipation of future profits only in the same sense that the sale of any depletable property is the anticipation of future income. This is because of the dual nature of all mineral property in that altogether they are property and altogether represent the right to future production and future profits. However, it is well settled that the outright sale of any mineral property (or a fraction thereof) is the sale of a capital asset despite the fact that the property has the unique quality of being also the right to future production.

Oil properties are unique and the sale of an oil payment is sui generis and such a sale is utterly unlike the assignment of income from a non-depleting corpus.

3. The retention of a reversionary interest does not convert that which is otherwise a capital asset into income. Various types of reversionary interests are involved in many different types of oil transactions and the retention of a reversionary interest or a possibility of reverter has never been thought to affect the character of what is sold. If the purchaser of a carved out oil payment has purchased a capital asset, as he clearly has, the seller must have sold one.

If by some remote analogy, a principle roughly akin to the *Horst* principle[1] is to be extended into this area, it seems

[1] *Commissioner v. Horst*, 311 U. S. 112 (1940).

obvious that while there may be some significance in the retention of a reversionary interest, if the oil payment sold is insignificant in relation to the property kept, such retention has no relevance whatever if the opposite is true and the oil payment is substantial and the reversionary interest remote.

The Government's position, as applied to long-lived oil payments, clearly violates the basic purpose of Congress in that it would create the very hardship which Congress sought to avoid in Section 117; also, its contentions literally applied, would mean that all sales of all mineral properties would be taxed at normal rates.

B. With respect to "short-lived" oil payments, a review of the administrative history discloses that for 25 years the policy of the Treasury was to recognize that all sales of carved out oil payments, irrespective of their substance or duration, were sales of capital assets within the meaning of the statute.

In 1946, the policy was changed and sales of "short-lived" oil payments (e. g., those ordinarily paying out in one or two years) were held to be subject to the normal rates. A similar rule was adopted relative to gifts,—gifts of "short-lived" oil payments were for the first time treated as assignments of future income.

In 1950, these rules were extended by I. T. 4003[2] to provide that all carved out oil payments, irrespective of size or duration, should be treated as assignments of income.

[2] *I. T. 4003, 1950—1 Cum. Bull. 10.*

After the Fifth Circuit refused to accept this extreme view as applied to oil payments having lives of from nine to 13 years, the Government has been urging the Insubstantial Transfer Rule, e. g., that those carved out oil payments which are substantial should have capital gain but insubstantial ones subject to normal tax treatment. Here it argues, first, for the extreme view of I. T. 4003 and alternatively for the Insubstantial Transfer Rule.

Three courses are open to the Court: (1) the extreme position taken in 1950 by I. T. 4003; (2) the other extreme (the rule for 25 years) that all oil payments are capital assets within the meaning of the statute; or (3) the Insubstantial Transfer Rule.

Of the three, clearly the extreme view taken in I. T. 4003 (the Government's primary contention here) is, for the reasons stated, clearly untenable. This ruling violates the basic purpose of the Act and is sheer legislation; there is nothing in the sale, for example, of the 12-year life oil payment in the *Fleming* case,[3] that even remotely resembles a prepayment of rent; it is no more the sale of income than the sale of the entire interest of any mineral property is the sale of income.

Of the two remaining courses, we believe the safest course, on constitutional grounds, is to follow the letter of the statute and leave the problem of the "short-lived" oil payment, to Congress if Congress deems it a problem. Here the letter of the statute and of the Committee Reports

[3] *Commissioner v. Fleming*, 241 F. 2d 78 (5th Cir. 1957), before this Court, on Writ of Certiorari, together with the instant case.

would be followed. Here the rule in force for 25 years and which has received implied legislative approval would be followed. The problem of the short-lived oil payment and its various ramifications in other areas, and of where a proper line should be drawn, is best left to Congress.

Alternatively, the Court should adopt the Insubstantial Transfer Rule, which is the Government's alternative proposition. Here the Court would be following the approach suggested in its previous decision in the *Schaffner* case,[4] by the Second Circuit in the *McAllister* case,[5] and by Judge Tuttle in the *Hawn* case.[6] This would make the question of whether the sale in a particular case is a sale of a substantial and durable property interest or simply the anticipation of income to depend on the facts of each case; its substantiality; its expected life; its relation to the reversion and whether the particular sale, under all the facts, appears to come within the stated intent and purpose of Congress. Such determination as in *Clifford*[7] and *Culbertson*[8] would be left to the trier of the facts.

Thus the Court should either affirm all the cases or should adopt the Insubstantial Transfer Rule. If such rule is adopted the Court should make this the rule of law to be applied in these cases, and, for the guidance of the lower courts, indicate, as in *Culberston*, the factors to be considered in each case. In such event, the Court should remand

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[4] *Harrison v. Schaffner, 312 U. S. 579 (1941).*

[5] *McAllister v. Commissioner, 157 F. 2d 235 (2d Cir., 1946), cert. den. 330 U. S. 826.*

[6] *Commissioner v. Hawn, 231 F. 2d 340 (5th Cir., 1956).*

[7] *Helvering v. Clifford, 309 U. S. 331 (1940).*

[8] *Commissioner v. Culbertson, 337 U. S. 733 (1949).*

some of the pending cases for a determination of substantiality.

II.

If the Court should adopt the Insubstantial Transfer Rule, the *O'Connor* case should, in any event, be affirmed; a remand here is unnecessary since the trier of facts has made all essential findings: (1) that the oil payment in question was long and not short-lived; (2) that the taxpayers sold a substantial and real property interest, representing a substantial part of taxpayers' royalty interest; and (3) that taxpayers did not assign income but sold a capital asset within the meaning of Section 117. Such findings, supported by the record and by the Court of Appeals, are entitled to finality. Of course, if the Court leaves the matter of "short-lived" oil payments to Congress, our primary contention, this case must be affirmed.

ARGUMENT

Part I—The Legal Principles

The broad question in this case is whether the sale of a carved out oil payment is the sale of a capital asset under sec. 117 or a sale of (the anticipation of) future income. The answer involves the consideration of the treatment to be accorded the "long-lived" oil payment, the "short-lived" oil payment and those in between. Underlying is also the Constitutional question of the scope of this Court's power to legislate the sensitive area of tax rates.

The Government contends (1) that the sale of all carved out oil payments, irrespective of life, are to be treated as assignments of future income; and alternatively, that those insubstantial in nature should be so considered but that those which are substantial should be given capital gain treatment.

We believe the problem can best be handled if we first consider oil payment sales generally, viewing such sales both from the standpoint of the Congressional intent and purpose and from the standpoint of the anticipatory assignment of income rules. Following this general treatment we will then deal specifically with the problem of the short term oil payment and consider the three possible courses open to the Court.

This Part I of the brief will be confined to the legal principles. Part II will consider the facts and findings in the *O'Connor* case in light of such principles.

A.

Oil Payment Sales Generally

Before considering the problem of the short term versus the long term oil payment, two general principles must be first recognized: (1) That Congress intended to extend capital gain treatment to sales of carved out oil payments, and (2) that the sale of an oil payment, at least a long term one, is not a sale or assignment of future income.

1. *The Sale of an Oil Payment is the Sale of a Capital Asset Within the Intent and Purpose of Sec. 117, as well as its Letter.*

Oil payments are not simply a tax device designed to convert ordinary income into capital gains. Oil payments were a recognized form of mineral interest long before the adoption of the capital gain provisions in 1921. They have played an important part in the development of the vital oil industry, and serve many useful functions in the day to day operations of that industry.[9] Oil payments are, every day, assigned to drilling contractors for the drilling of oil wells; to supply houses for the equipping of wells; to geologists, petroleum engineers, land men, lawyers and others to assist in the search for oil or in the development of oil properties. They are sold or pledged to secure funds for development.[10] They may be carved out and retained in connection with a farm-out or other grants. Most sales of producing properties are accomplished through the oil payment or so-called ABC transaction.[11] In partial or complete liquidation of an oil corporation, an oil payment, for sound business reasons, may be transferred to one or more of the shareholders, and the working interest, subject to the oil payment, to other stockholders. Oil payments may be given to charity or in trust or otherwise to a member of the family.

[9] For the convenience of the Court, we have summarized in Appendix B, p. 63 infra., the tax treatment accorded to various oil transactions including the various transactions in which oil payments play a part. On the general subject of the various uses and their tax treatment see, *Trevathan, Federal Tax Aspects of Oil Production Payments*, 35 *Taxes, The Tax Magazine* 179 (1957).

[10] See Tax Treatment, Appendix B, p. 68 infra., *Development Oil Payments*.

[11] See Tax Treatment, Appendix B, p. 71 infra., *The ABC Transaction*.

By will, a widow may be devised an oil payment and the working interest, subject to the widow's oil payment, devised to the sons. Thus they have many uses.

Oil payments, however created, and for whatever purpose, are property. Under the law of Texas and most of the twenty or thirty oil producing states, they are real property.[12] They are also property under the federal tax laws, being an economic interest in oil in place. *Thomas v. Perkins, 301 U. S. 655 (1937); Anderson v. Helvering, 310 U. S. 404 (1940).*

Since the sale of an oil payment is the sale of "property" it falls within the letter of Sec. 117.[13] Unless the seller is a dealer, buying, selling and trading in oil properties, the sale does not fall within any of the enumerated exceptions prescribed by the statute. If the sale, as in the *O'Connor* case, is out of a royalty interest, it is a sale of a part of the taxpayer's investment property; it is not a sale of stock in trade or of inventory or of property held primarily for sale to customers in the ordinary course of a trade or business. The royalty owner, generally, is not engaged in a trade or business, and the Court found that the taxpayers in the *O'Connor* case were not so engaged. (R. 76.) If the sale is out of a lease or working interest,[14] it is the sale of "real property used in (the seller's) trade or business," and thus literally falls within the provisions of Section 117(j) unless, again, the seller is regularly engaged in the business of trading in leases.

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[12]See Tax Treatment, Appendix B, p. 66 infra, *Oil Payments.*

[13]Appendix A, p. infra.

[14]See Tax Treatment, Appendix B, p. 63 infra, *Lease.*

The sale is also within the intent and purpose of Section 117. The capital gain provisions were incorporated in the revenue laws by the Revenue Act of 1921. In its report on this new provision, the Ways and Means Committee stated (Report—Ways and Means Committee, 67th Cong., 1st Sess., H. Rept. 350):

> "The sale of farms, *mineral properties*, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. * * * In order to permit *such transactions* to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section. * * *."[15]

An oil payment is certainly a "mineral property," and, as the Committee Reports clearly show, Congress intended to permit sales of such to go forward at the new capital gain rates.

In *Burnet v. Harmel, 287 U. S. 103 (1932)*, this Court held that the current production and sale of royalty oil, though technically a sale of property, was not within the intent and purposes of the capital gain provisions. Taking note of the foregoing Committee Reports, this Court there said:

> "The provisions of the 1921 Revenue Act for taxing capital gains at a lower rate * * * were adopted *to*

[15] Seidman's Legislative History of Federal Income Tax Laws, p. 813. Likewise in the Report of the Senate Finance Committee (67th Congress, 1st Sess., Senate Report 275), it was stated:

> "* * * Under the present law many sales of farms, *mineral properties*, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206. * * *."

relieve taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions. * * *.

"But notwithstanding this incidental transfer of ownership, it is evident that the taxation of the receipts of the lessor as income does not *ordinarily* produce the kind of hardship aimed at by the capital gain provisions of the taxing act. * * * (T)heir abstraction from the soil is a time-consuming operation and the payments made by the lessee to the lessor (sic) do not normally become payable as a result of a *single transaction* within the taxable year, as in the case of a sale of property * * *.

"* * * Such operations * * * have been said to resemble a manufacturing business." (Emphasis added.)

Under this decision the sale of an oil payment must be regarded as falling within the purpose and intent of Section 117 as well as its letter. It is a sale of realty, not of personalty. It is a bulk sale of a large quantity of oil in place which is, and remains, realty. Here we do not have the day-to-day, recurring conversion of realty into personalty. We do not have the time-consuming operations involved in daily sales. There is nothing that slightly resembles a manufacturing process. The sale is "a single transaction within the taxable year as in the case of the sale of property." The sale falls within the purpose of Section 117, which was "adopted to relieve the taxpayer from the excessive tax burdens resulting from a conversion of capital investments." To tax the sale of most oil payments as normal income would "produce the kind of hardship aimed at by the

capital gain provisions" since it would "bunch" in a single year and tax at surtax rates graduated up to 91%, not just six months of profits, but profits of a number of years.

Unless the Court is prepared to overrule its decision in the *Harmel* case, the sale of an oil payment must be regarded, under that decision, as falling within the purpose and intent, as well as the letter, of Section 117.

The Government admits that an oil payment, per se, is a capital asset within the meaning of Section 117. If a taxpayer has purchased an oil payment and six months later sells it, or a fraction of it, it is acknowledged that he has sold a capital asset and is entitled to capital gain treatment. If on sale of a mineral property the seller carves out and retains an oil payment and later sells the oil payment, or a fraction thereof, it is recognized that he has sold a capital asset. If a development oil payment is carved out of a larger property and assigned to another for cash which is earmarked or pledged for development, or is assigned to a geologist or engineer for his services in engineering or developing the property, it is recognized that the new owner of the oil payment holds an economic interest in oil in place and should he sell it, or a fraction of it, he has sold a capital asset. Such oil payments are acknowledged to be capital assets, even though their economic life be as short as one or two years.[18]

[18] See Tax Treatment, Appendix B, pp. 66-68, infra, *Oil Payments. Development Oil Payments.*

Thus it is the government's position that all oil payments are capital assets except those carved out of a larger interest (then only if the proceeds are not earmarked or pledged for development). As to such payments the taxpayer is held not to have sold property within the meaning of Sec. 117, but to have assigned future income.[17]

2. *The sale of a carved out oil payment is not the sale of or anticipation of future income.*

If a taxpayer receives a prepayment of rent he is in receipt of normal income and must pay tax at normal rates in the year of receipt, whether he be on the cash or accrual basis of accounting. The lessee amortizes his rental payment over the period to which the payment relates. Likewise we may assume that if a taxpayer sells to a third party his right to receive future rents from property, or dividends declared and unpaid, or interest on a bond yet unaccrued, he will be deemed to have sold income as such and his receipt is to be taxed at normal rates. What he receives is but a substitute for what he would have received had he

[17]We do not deem it necessary to labor the point made by the Government (Br. 33-41) that the sales in question were not sales of property but "conferred only a contractual right." We do not know what this means unless a deed passing title to real property, duly delivered and recorded in the county where the property is located, conferred a "contractual right." Of course, a contractual arrangement could exist, such as a guarantee of the oil payment. This would cause the seller to be taxed on the income from the oil payment received by the buyer as it paid out and would eliminate all tax on the proceeds of the sale. See Tax Treatment, Appendix B, p. 69, infra, *Guaranteed Oil Payments*. No "contractual arrangement" was present in the *O'Connor* case, except the sale itself. (R. 75.) Also we pass the contention that at most the assignments conveyed oil, which is not a capital asset. (Br. 42.) Of course, every sale of every mineral property conveys only oil,—oil in the ground.

not anticipated his income by the sale.[15] However, a sale of a carved out oil payment is not the sale of income in the sense of a prepayment of rent or the sale of future dividends or the sale of coupons clipped from a bond. Rents, dividends and interest represent income "derived from" capital. They are payments received for the use of money or property; and, when received, they are separated from the producing corpus; they are the earnings or products of the corpus; the corpus remaininng intact, capable of producing income in future years. The right to receive rents, dividends and interest is an intangible property right, a contractual right, but their identity as income—as derivative of and separate and apart from the corpus—is clear and unmistakable.

But profits from the production and sale of oil is not income "derived from" an income-producing property. It is not income in this derivative sense at all; it is the profit derived from the sale of property. Any interest in an oil and gas property, whether that interest be an oil lease, a royalty, or a limited overriding royalty or oil payment, represents title to and ownership of a specific number of

[15]There are a few rules to this effect, although the extent of the rule is yet to be developed. *Lum v. Commissioner of Internal Revenue, 147 F. 2d 356 (3rd Cir. 1944).* Whether the rule would be extended to the sale of the right to the use and occupancy of a property for a term of years or whether it would be extended to the sale of all of the coupons on a ten or twenty year bond is yet to be announced. The cases relied on by the Government relating to the sale of income *already earned* are clearly irrelevant. They involve another principle that *earned* income was intended to be taxed to the earner at normal rates and one who has already earned income may not, by an anticipatory sale, convert this chose in action into a capital asset, c.f., *Safety Car Heating Co. v. U. S., 297 U. S. 88 (1936).* See also, *Beard, 4 T. C. 756 (1945) (A); Hobby, 2 T. C. 980 (1943) (A),* and compare *Henrietta Mills, Inc. v. Commissioner, 52 F. 2d 931 (4th Cir. 1931),* and *F. Rodney Paine v. Commissioner, 236 F. 2d 398 (8th Cir. 1956).*

barrels of oil under the ground. The number of barrels in place is limited. They may be comparatively few in number, or, as in the case of the East Texas Oil Field, they may be in sufficient quantity to give the property a life of perhaps 30 years. But as each barrel is produced and sold, that barrel is gone forever, and gradually as additional barrels are produced and sold, all will sooner or later be gone. This oil in place is real property. When a barrel of oil is produced, it is converted at the surface into "personalty," but it is still tangible property. When the barrel of oil is sold, there is a gain or profit on its disposition. This gain or profit is the difference between the unit cost of that barrel of oil and its selling price,[18] but this profit is obviously not income such as rents, dividends or interest, which are derived from a non-depleting corpus. It is the profit from the sale of property. To use the hackneyed illustration, the sale of a barrel of oil is not the sale of the fruits from the tree; it is, rather, the sale of a piece of the tree itself.[19]

Nor is the sale of an oil payment the sale of income to be derived from a retained corpus. It is the sale in bulk of barrels of oil in place. It is the sale of real property, not an intangible right to income to be derived from real property. It is a sale of a large part of the property or the "tree." That which is sold is not "derived from" that which is kept.

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[18] Under the Treasury Regulations, the cost of the entire oil property is divided by the estimated number of barrels of oil in place, in order to arrive at a unit per barrel cost. Regulations 39.23 (m)-2 under the 1939 Code. Of course, the taxpayer may use statutory depletion in lieu of cost depletion.

[19] Under the *Harmel* decision, this recurring, piecemeal, day-to-day sale is taxed at normal rates, not because it is "derivative income" but because, though literally a sale of property, it is not the type of [illegible] recurring, isolated profit which Congress had in mind in enacting the capital gain provisions.

The retained property, representing the reversionary interest, is not the corpus, nor is the oil payment the income to be derived from that corpus. The oil payment on the one hand, and the reversionary interest on the other are separate and different parts of the mineral content in place. The sale of an oil payment is not the temporary assignment of the fruits from property. It is the absolute disposition of property itself, which property is extracted and consumed by the buyer, and which property never comes back to the seller. Clearly, the sale of an oil payment is not a sale of derivative income, as in the case of the advance sale of interest, dividends or rents.

The sale of an oil payment is not the assignment of income from property. It is, however, the *anticipation* of future income in the limited sense that it is a sale of property that carries with it the right to future production and profit. It is a sale of or anticipation of future income only in the sense that had the sale not been made and had the oil been retained and produced on a barrel by barrel basis, this same oil would, under the *Harmel* decision, have been taxed at normal rates, when and as produced. In this sense, the sale of any mineral property, hardrock or hydrocarbons, involves the sale of or anticipation of future income. This is because of the depletable nature of all mineral deposits. All mineral properties are "property", and at the same time in their entirety, represent future profits. Any mineral property, kept and produced to the end of its economic life (whether it be two years or twenty), will all be ordinary income. After exhaustion there will be no property left

because all of its has been consumed in the productive process. Thus the sale of any mineral property is the sale of property, carrying with it the right of future production ..til fully consumed. In this sense it is also the sale of the right to future profits.

It is the unique and dual nature of a mineral property, being at the same time both property and all future profits, that apparently has been overlooked by the government. If the sale of an oil payment, though clearly a mineral property, is to be taxed at normal rates simply because it also includes the right to future production, then every sale of every mineral interest must be taxed in the same way for the same reason. Yet such is not the case. Nor does the government contend for this position.

All of the decisions since the *Harmel* case have consistently recognized that mineral properties, including leases, royalties and oil payments, are capital assets, even though oil proceeds are normal income and even though the sale of the property, or a portion thereof, carries with it this inherent right to future income.[21] As stated in *J. E. Murphy v. Commissioner, 9 B. T. A. 610, 616 (1927) (Acq.), affirmed without opinion Ct. App. D. C. Feb. 10, 1930*, in al-

[21] See *W. P. Ferguson v. Commissioner, 45 F. 2d 573 (5th Cir. 1930); Burkett v. Commissioner, 31 F. 2d 667 (8th Cir. 1929); Chesson v. Commissioner, 57 F. 2d 141 (5th Cir. 1932); Glide v. Commissioner, 75 F. 2d 1014 (9th Cir. 1935); Hirschi v. U. S., 67 Ct. Cls. 637 (1929); Henry Berg, 33 F. 2d 641 (D. C. Cir.), cert denied, 280 U. S. 615 (1930); D. R. McDonald, 7 B. T. A. 1078 (1927); J. D. Reynolds, 10 B. T. A. 651 (acq.), affm'd on authority of Berg, et al. v. Commissioner (D. C. Cir.), Feb. 20, 1930; J. E. Murphy, 9 B. T. A. 610 (1927) (acq.), affm'd without opinion (D. C. Cir.), Feb. 10, 1930; Hazlett, 10 B. T. A. 332 (1928); Parkey, et al., 16 B. T. A. 441 (1929); Abel Bliss, 16 B. T. A. 538 (1929); Eli K. Price Est., 23 B. T. A. 1192 (1932); Goforth, 32 B. T. A. 1206 (1936).*

lowing capital gain treatment on the sale of a royalty interest:

> "To hold otherwise would be to give to a relief statute a narrow construction which would do violence to the intention of Congress as expressed both in the words of the section and the report of the Committee on Ways and Means of the House of Representatives."[22]

This has also been the consistent practice of the Service, both before and after the *Harmel* case.[23]

Obviously, therefore, mineral properties are sui generis. They are unlike other forms of property. They are relatively short-lived, and thus unlike other forms of property having perpetual life. They are depletable, and thus are unlike other properties capable of reproducing income forever. They are unique in that they are property and at the same time future profits; but this future profit is unlike the dividends, interest and rents derived from a non-depleting corpus. Because of their unique nature it is clear that the sale of an oil payment is utterly unlike the sale of

[22]Here the Court was referring to the stated intent in the Committee Report that sales of "mineral properties" should have the benefit of the capital gain rates.

[23]*I. T. 2017, III-2 C. B. 47; GCM 4299, VII-2 C. B. 116; Rev. Ruling 55-526, 1955-2 C. B. 574.* Thus, in *G. C. M. 12118, XII-2 C. B. 119 (1933)*, published shortly after the *Harmel* decision, it was stated:

> "* * * The case of *Burnet v. Harmel*, supra, establishes the principle that all payments from lessee to lessor under an oil and gas lease are income from the use of the land and are not gain from the sale or conversion of capital assets. This rule should be applied in all cases where the instrument of grant may be classified properly as a lease. This office is of the opinion, however, that in the case of an unlimited conveyance for a cash consideration of the lessor's reserved royalty under an oil and gas lease or of a fractional interest therein, as in the case of *J. E. Murphy v. Commissioner*, supra, and the *Appeal of Anna Taylor*, supra, the conveyance may be treated as a sale of a capital asset within the purview of the capital gain provisions."

dividends declared and unpaid or coupons clipped from a bond. Cases dealing with such sales have little bearing and even less applicable are the donative assignment of income cases where the question is *who*, among the members of a family group, shall be taxed following a gift of future derivative income, the donor retaining the corpus that produces it. Here the question is, did Congress intend to give capital gain treatment to the sale of this unique mineral property.

All the cases hold, and the Government acknowledges, that Congress did intend to give capital gain to the sale of an oil payment (or other mineral property) even though the property has only a two or three year remaining life, provided the taxpayer sells all of it or a fraction of it, but the Government's position is that Congress did not intend capital gain treatment if the taxpayer sells a two or three year life oil payment, out of a larger interest, retaining a reversionary interest. Both oil payments are real property under state law; both represent economic interests in oil in place under Federal tax laws; both are "property" within the letter of sec. 117; both are "mineral property" within the stated purpose of the Committee Report; quantitatively, both represent the ownership of the same number of barrels of oil in place; and both involve to the same degree the right to future production. The only difference is that in the one case the taxpayer has sold all (or a fraction of all); in the other he has retained a reversionary interest. Did Congress intend to deny capital gain treatment simply because the seller has retained a reversionary interest?

Logically the retention of a reversion should not affect the character of what is sold; or convert what is otherwise a capital asset into normal income. Certainly the carved out oil payment in the hands of the buyer is a capital asset, and if he should sell it six months after purchase he would, admittedly, have capital gain.[24] If the buyer has bought a capital asset, logically, the seller must have sold one.

In any event its seems abundantly clear that even though the retention of a reversion may be deemed to have some significance if the oil payment is small and the reversion very large, the same retention of a reversion has no significance whatsoever if the reverse is true and the oil payment is very large and the reversion so small as to become not a reversion, but a mere possibility of reverter.

In the oil industry, sales of property are frequently made subject to various reservations. Such reservations have never been thought to affect the character of the property that is sold. Thus, the sale of a landowner's royalty under an oil and gas lease, is the sale of a capital asset even though the minerals will revest in the landowner on termination of the lease.

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[24] I. T. 4003, 1950-1 C. B. 10; *Thomas v. Perkins*, 301 U. S. 655. (1937.) The Government's contention that the assignments "conveyed to the assignees only the contractual rights to collect a portion of the *assignors'* future oil proceeds (Govt. Br. 39.) is obviously contrary to the law and facts and is utterly unrealistic. The assignees, by recorded deed obtained title to oil in place,—a real property interest. They alone thereafter owned the oil; they alone could sell it; or they could have taken it in kind; if a blowout or other loss occurred, the risk was theirs. As owners they could produce it, sell it or borrow against it. The very fact that the Government suggests a distinction in the case of the development oil payment (Fn. 19; Fn. 39) points to the fallacy. What is the source of this distinction? Certainly the character of an oil payment as an economic interest in oil in place, as explained in *Thomas v. Perkins*, supra, is not affected either by the circumstance of its creation or the use of the funds received from its disposition.

A sale of a lease is the sale of a capital asset even though the buyer be required to drill a well or to perform other acts which if not performed will cause the property to revert. The sale of a lease is the sale of a capital asset, though the seller may reserve the deep rights. An agreement, on the sale of a lease, that the buyer shall drill a well; that if it be an oil well the buyer keeps it, but if it be a gas well the property revests in the seller, does not affect the capital gain character of the properties sold.

The carried interest [2] is a capital asset, and the sale of property subject to a carried interest contract will entitle the seller to capital gain despite the provision that a fractional interest will revest in the seller after the buyer has recouped his cost. Also the sale of a royalty or a lease is subject to capital gain though the seller retains an oil payment.

We submit the reversionary interest or possibility of reverter retained on the sale of an oil payment, certainly as to a long lived oil payment, does not change the character of the asset sold.

Up to this point we have been discussing the sale of carved out oil payments generally. As to long-lived oil payments, the following conclusions are, we submit, entirely sound and not open to serious question:

1. The sale of a long lived oil payment is the sale of a capital asset within the clear intent and purpose of sec. 117, as well as its letter.

[2] See, Tax Treatment, *Carried Interest*, Appendix B, p. 73, infra.

2. The sale of a long-lived oil payment is not the sale or assignment of income from property.

3. The retention of a reversion in the case of the sale of a long-lived oil payment does not convert the oil payment into something other than a "mineral property."

We now turn to the problem of the "short-lived" oil payment.

B.

The Problem of the Short-Lived Oil Payment

Despite the validity of the general principles above discussed, it might be conceded that the statute as written should be revised to deal with the problem of the sale of carved out oil payments of relatively short duration. While the sale is a sale of a mineral property, this property carries with it the right to the first production. Discountwise, the first production is the most valuable oil in place. Since the buyer is entitled to the first production his risk, in the case of settled production, may be so slight as to justify his paying a price only a little under the anticipated revenues from the property.[25] Where the oil payment is "short-lived" or "insubstantial" and the reversionary interest relatively large, one unconsciously is inclined to emphasize this right to the first production and to look only on the one side of the oil payment coin which says, "This is the right to future production; this is the anticipation of

[25]Of course the same is true of the outright sale of any oil payment or royalty interest, the life of which is short and its productivity over its remaining life ascertainable. The difficulty with the "short-lived" oil payment lies not in the degree of risk or certainty of pay out, but in its insubstantiality in relation to the interest retained.

future profits"; but as the life of the oil payment is extended and its substantiality increases, the first impression that the sale is but the anticipation of future income recedes and one sees only the side of the coin which bears the inscription, "This is, indeed, a mineral property." It is this dual nature of mineral property, being both a mineral property and at the same time the right to future production that makes a "short term" oil payment appear to be an "assignment of future income." It is not an assignment of income but it is an anticipation of future profits, just as the sale of any short lived mineral property is. It is also the sale of a mineral property.

In certain well defined situations Congress might well have recognized that the sale of a "short-lived" oil payment, though the sale of a mineral property, was, in effect and as a practical matter, only an anticipation of future income. Congress could have done any one of several things. It could have said that the sale of any mineral property, whether it be the sale of a carved out oil payment or the sale of an entire interest, should be denied capital gain treatment if it had a life of no more than one or two years. Or it could have denied capital gain treatment to all sales of carved out oil payments; or it could have said that carved out oil payments having an anticipated life of no more than one, two or five years should be excepted. Or it could have excluded carved out oil payments where the interest sold did not represent more than 10%, or some other percentage, of the underlying reserves.

The trouble is, Congress has done none of these things, and has simply stated that it intended to give capital gain treatment to the sale of "mineral properties." The question here is whether this Court, within the limits of its Constitutional power of interpretation, shall attempt to do what Congress has not done.

Before taking up the three courses open to the Court, a brief history of the judicial and administrative treatment of short term oil payments may prove helpful.

Aside from the lower courts' decisions in these cases, there are several older cases which apparently have received implied legislative approval, all of which have recognized that the sale or assignment of all carved oil payments, "short-lived" and "long-lived" alike, were sales or assignments of property, not of future income, and the existence of a reversionary interest did not change the character of the property so conveyed.

Thus in *R. E. Nail, 27 B. T. A. 38*, decided in 1932, the taxpayer made a valid assignment of an oil payment out of his royalty interest, to a trust. The oil payment "paid out" in less than a year. The Court said:

> "Here it is apparent that there was a complete transfer of decedent's present interest in the property. She kept a reversionary interest, but that gave rise to no income. The income here involved arose from the property conveyed and belonged, not to Mrs. Cook, but to the trust."

The Treasury acquiesced in this decision (Acq. XII—1 Cum. Bull. 3, 1939).

In *Ortiz Oil Company, 37 B. T. A. 656, affirmed by 102 F. 2d 508 (5th Cir., 1939)*, a corporation sold an oil payment out of a larger interest; the oil payment paid out in less than four years. The Board of Tax Appeals (at page 664), affirmed by the Fifth Circuit, held, in unmistakably clear language, that a *sale* of property had been made by the taxpayer:

> "The transaction constituted a *sale* by petitioner *of oil in place* and it *realized taxable gain* thereon in the amount of $154,000 less the amount of the cost bases allocable to the oils required to discharge the oil payments. * * *." (Italics supplied.)

Again in *Majestic Oil Corporation, 42 B. T. A. 659*, decided in 1940, the taxpayer sold a carved out oil payment for $63,500 cash and claimed depletion on the sale. There the Government took the position, diametrically opposed to its present position, that (p. 664):

> "The $63,500 received by the petitioner from Royalty during 1935 was *not 'income from the property'* within the meaning of section 114(b) of the Revenue Act of 1934; that the petitioner *sold an economic interest in its lease* with Shell to Royalty [Royalty was the purchasing company], and under the decision of the Supreme Court in *Thomas* v. Perkins, 301 U. S. 655, the petitioner is not entitled to depletion in respect of the $63,500 received from the *sale of such economic interest.*" (Italics supplied.)

The Board of Tax Appeals, relying on the *Ortiz* case, supra, sustained the Government's position.

See also *Nordan, 22 T. C. 1132 (1954)* (Government's appeal dismissed) (gift of an oil payment to a church held to be gift of property and not of future income).

Thus all of the decisions since 1932 are contrary to the Government's present position. There are none in its favor. During these years Congress has repeatedly reenacted the capital gain provisions. While numerous amendments have been adopted to remedy certain defects, no change has been made in the provisions giving capital gain to the sale of mineral properties. The rule of implied legislative approval is applicable.

In addition, for twenty-five years following the enactment of the capital gain provisions in 1921, it was the consistent policy of the Treasury Department to recognize that sales of carved out oil payments were entitled to capital gain treatment, even though the oil payment had only an expected life of a year or two. During this period, many private rulings to this effect were issued. It was this policy that caused its acquiescence in the *Nail* case, supra, in 1932. And it was this policy that the Government itself successfully urged in the *Ortiz* case, supra, in 1939, and again in the *Majestic* case, supra, in 1940.[27]

This long established administrative policy, it can be said, received Congressional approval through the repeated re-enactment of the statute without change.

[27] And see G. C. M. 22730, 1941-1 Cum. Bull. 214, where it was said:

"Unlike ordinary rights to rent or royalty, oil payment rights represent share rights in only a portion of the oil or mineral content of the land. When the stipulated payments are made, the payee's interest in oil or mineral expires. A cash payment made upon the execution of an instrument stipulating only for oil payments is, therefore, regarded not as an advance royalty payment but as proceeds from a sale in which the payee disposed of his economic interest in oil or mineral in place, less the fraction thereof represented by the oil payment rights reserved by him."

Not until 1946 (25 years later) was there any change in this settled policy. In that year the Treasury detected what it thought was a defect in the law in applying capital gains to short lived oil payments. Instead of asking Congress for an amendment to the capital gain provisions, it undertook to cure the defect administratively.

1. First, in 1946, it promulgated G. C. M. 24849, 1946—1 Cum. Bull. 66. This ruling denied capital gain treatment to "short-lived" oil payments; e. g. those, as stated in the ruling, that "ordinarily pay out and expire within one or two years."[28]

2. In 1949 it ruled that *donative* assignments of "short-lived" oil payments carved out of a larger interest are "assignments of future income." I. T. 3935, 1949—1 Cum. Bull. 39.[29]

3. In 1950 both of the foregoing rulings were extended to cover all carved out oil payments, irrespective of life. The sale of such an oil payment was held to result in ordinary income; and a donative assignment was considered as the assignment of future income. I. T. 4003, 1950—1 Cum. Bull. 10.[30].

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[28] Since the taxation of the sale of "short-lived" oil payments as ordinary income represented a change in existing policy, G. C. M. 24849 was made to apply to such sales made after April 1, 1946, (I. T. 3895, 1948-1 Cum. Bull. 39). Miller, in an article entitled "Selling 'Oil Payment'," 27 Taxes, The Tax Magazine 185 (1949), discusses G. C. M. 24849.

[29] In that ruling the previous acquiescence in the *Nail* case, supra, was withdrawn. Again since this ruling changed existing practice, the ruling was effective only to donative assignments made after January 24, 1949.

[30] This new ruling was expressly held not to apply where the assigned oil payment right constitutes the entire depletable interest of the assignor or a fraction extending over the entire life of the property.

4. After the *Caldwell* case refused to follow I. T. 4003, the Government, in the *Hawn* case,[41] and again in the court below, receded from the extreme position in I. T. 4003 and argued for the Insubstantial Transfer Rule, e. g., that substantial carved out payments should be allowed capital gain but insubstantial ones should be regarded as sales of future income. This Insubstantial Transfer Rule, in substance, was the readoption of the 1946 ruling of the Bureau (G. C. M. 24849) that "short-lived", as distinguished from "long-lived" oil payments, should be taxed as ordinary income.

5. In its brief here, the Government now withdraws its previous concessions that I. T. 4003 went too far, and reasserts its former position that all sales of all carved out oil payments, irrespective of life, are assignments of income. Only alternatively does it contend for the Insubstantial Transfer principle.

As this administrative history shows, the problem of the "short-lived" carved out oil payment is not new. Three different positions have been taken since 1921, and three courses are open to the Court:

(1) To adopt the position taken in 1950 in I. T. 4003 (the Government's primary contention here) that the sales of all carved out oil payments, regardless of anticipated life, are sales of income;

(2) To follow the clear language of the statute and committee reports and allow capital gains to all carved out oil

[41] *Commissioner v. Hawn*, 231 F. 2d 340 (5th Cir., 1956).

payments, even the short lived ones (the policy of the first 25 years), and leave the short lived problem to Congress.

(3) To adopt a middle ground, and limit capital gains to substantial oil payments (in effect to adopt the 1946 ruling).[32]

1. *I. T. 4003 (the Government's Primary Contention) is Clearly Wrong.*

It is respectfully submitted that I. T. 4003 (the primary contention of the Government) is, without question, wrong. I. T. 4003 holds that every carved out oil payment, no matter how substantial or how long its life, is to be denied capi-

[32]We omit, as a possibility, the adoption of the "loan" theory of the Seventh Circuit in *Commissioner v. Slagter*, 238 F. 2d 901 (1957). There, the Court treated the sale of a carved out oil payment as if it were not a sale at all but a loan or advance, thus holding the seller should remain taxable on the income in the hands of the purchaser, with the result that there was no tax on the sale at all (normal or capital gain). Thus the Court adopted a very literal application of the donative assignment of income cases. The decision is favorable to the taxpayer in these cases, since it would mean that the Government has asserted the wrong tax in the wrong years, and there would be no tax due in the years before the Court and limitations will have barred collection in the later years. However, we believe the *Slagter* case is wrong and the Government agrees that the *Slagter* case is wrong. The claim of right doctrine now advance by the Government (Gov. Br., Fn. 11) is clearly applicable. If the sale is bona fide, the taxpayer should account for the consideration in the year of receipt when it is subject to his unqualified disposition and command. He should not be taxed on another's income in other years. As a matter of sound taxing policy, he should pay his tax when he gets the money and the Government should not depend on his ability in future years to pay the tax. If the seller is not taxed on the cash receipt and the oil payment never pays out, the buyer will have a loss and the seller a tax-free windfall. Moreover, if the tax is not collected immediately, the tax will be lost should the seller die before the oil payment pays out. The most favorable thing that can be said for the *Slagter* case is that it produces a more equitable result than I. T. 4003 in that it spreads the tax in lower brackets over a number of years rather than grouping a number of years of profits in a single year. We submit the case is wrong, although it does illustrate the confusion resulting from attempted application of the donative assignment of income cases. Of course, the *Slagter* result would be right if the sale is not bona fide or if the oil payment were guaranteed. See Tax Treatment, *Guaranteed Oil Payment*, Appendix B, p. 69, infra.

tal gain treatment, simply because of a reversionary interest, or a possibility of reverter. It holds that all long-lived oil payments, even those extending to the full economic life of the property, are to be taxed as ordinary income. This would include the 13 year life oil payment in the *Caldwell* case and the 12 year life oil payment in the *Fleming* case. Here there can be no question about the Congressional intention. Certainly such long lived oil payments are "mineral properties" within the clear and unambiguous purpose of sec. 117, as expressed in the 1921 Committee Reports. To tax such long lived oil payments at ordinary rates would, without question, tax many years of profits in a single year at the highest surtax rates, and thus produce an extreme hardship, the avoidance of which was the principal aim of Congress in enacting the capital gains provisions, as this Court so clearly pointed out in the *Harmel* case.

All oil properties, sooner or later, exhaust themselves. Some have longer lives than others. The average life of an oil well is ten years or less. Admittedly the sale of the entire interest in an oil property (or a fraction thereof) was intended by Congress to have capital gain treatment. Can it be said, by any process of reasoning, that while Congress intended an entire interest having a life of less than ten years to be a capital asset, a carved out oil payment having a twelve year life should not be? The Government has pointed to no exception or other provision in the statute even slightly intimating such a distinction. Can it be said that Congress intended that one taxpayer owning an oil

payment having a life expectancy of only two years should have capital gain on its sale; but another who sells an oil payment out of a larger interest with an expected life of 20 years is to be taxed at 91%? Did Congress intend that A, who sells an entire oil payment representing 1,000 barrels of oil, should have capital gain; but B, who sells one involving one million barrels in place, has ordinary income if he retains a reversionary interest of so much as a single barrel? Did Congress intend that if a taxpayer should sell an undivided 10% interest in his royalty representing 1,000 barrels of oil in place, he is entitled to capital gain; but if he sells a carved out oil payment, representing the first million barrels of oil in place and representing 90% of his property, he has ordinary income because he has retained a reversionary interest in the last 10% of such oil in place? Surely, I. T. 4003 goes too far.

The sale of a long lived oil payment does not bear the slightest resemblance to a prepayment of rents. The seller has sold and the buyer has paid a substantial sum for a valuable, lasting and substantial mineral property. This property produces income in the hands of the new owner. The income received by the new owner is a depletion of the property interest he has bought. It is something that the seller never regains upon the termination of the interest sold. The sale is not a temporary assignment of the income from property; it is a completed sale of a very large number of the economic units in place, which are later extracted and consumed by the new owner.

I. T. 4003 was not adopted until 1950 (29 years after the adoption of the capital gain provisions).[33] Long established administrative practice, as well as all of the decided cases, are opposed to I. T. 4003. This past practice and these decisions have received implied legislative approval.[34] Any change in such accepted practice of such long standing should be made only by Congress. If this kind of mineral property, e. g., long term oil payments, are to be excluded from the capital gains provisions, Congress and not the Administrator should write the exception. I. T. 4003 is an attempt at administrative legislation.[35]

2. *The Problem of the Short-Lived Oil Payment Should be Left to Congress.*

If, as we believe, I. T. 4003 is clearly wrong, two alternatives are left: (1) To follow the letter of the statute and leave the curative work to Congress, or (2) to adopt the Insubstantial Transfer Rule. Of the two we submit, on constitutional grounds, the safest course is to follow the letter of the statute and let Congress handle the problem, if it deems it to be a problem. The point can best be tested by the isolated sale of a two year oil payment such as is referred

[33] And after its first test in the *Caldwell* case, the Government conceded that it went too far.

[34] As stated by the Court in *U. S. v. Leslie Salt Co.*, 350 U. S. 383, 396, (1956), "'Administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful * * *.' Against the Treasury's long-standing and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand."

[35] For a searching analysis of this ruling, see "Assignments of Oil Payments" by Eugene Kunz, Professor of Law, University of Oklahoma, 31 Taxes, The Tax Magazine 863 (1953), who concludes that while there is a rational basis for G. C. M. 24849, there is no justification at all for I. T. 4003.

to in G. C. M. 24849,[36] if a taxpayer sells an oil payment (his entire interest) with a two year life, it is acknowledged that Congress intended capital gain. I. T. 4003, Can we be absolutely sure that Congress did not intend the same result on the sale of a carved out oil payment with the same life? The best evidence is that Congress, for right or wrong, did intend such short-lived oil payments to enjoy the 25% rate. This is drawn not alone from the all-inclusive phrase "mineral property" as used in the Committee Report, but from 25 years of administrative interpretation which has received legislative approval, *U. S. v. Leslie Salt Co. (Cited in footnote 36, supra)*. Congress did say that it intended "mineral property" sales to have the benefit of the 25% rate; nowhere has it said, or even intimated that certain types of mineral properties should be excluded. Nowhere has it suggested that the retention of a reversionary interest will deny capital gain treatment to that which is otherwise admittedly a capital asset.

Granted there may be an imperfection in the Code. There are many such imperfections. It might be admitted that we

[36]Here we are not referring to the "device" type of case, or to sales which are not bona fide. Nor are we referring to one such as the three-months oil payment involved in the Rudco case [*Rudco Oil & Gas Company v. U. S.*, 82 F. Supp. 746 (Ct. Cls., 1949)], nor to the case of a taxpayer who may, repetitively, sell oil payments for the obvious purpose of converting his current production into capital gain. Should any taxpayer be so bold as to claim capital gain in such a case, the Courts would promptly deny it on the ground that it was essentially the sale of current production; that the taxpayer had not changed his position; that the sale showed only a tax, not a business purpose; that it did not involve the hardship aimed at by the taxing statutes and that *Harmel* applies. What we are now dealing with is an isolated sale, extending substantially beyond the year, but one, nevertheless, that is small in relation to the reversion, such as a two year oil payment referred to in G. C. M. 24849. It would be expected that should the Court affirm all of these cases (the shortest payment being twenty-eight months in the *Weed* case), it would make it clear that such decision does not constitute approval of the use of oil payments to convert current production into capital gain.

would have a better statute if Congress had denied capital gain treatment to sales of relatively short-lived oil payments; or better still if it were to deny capital gain treatment to sales of all relatively short-lived oil properties, whether oil payments, leases or royalties. But the curing of such imperfections is for Congress. Congress has, since 1921, from time to time, added many amendments and exceptions to the capital gain provisions as experience develops imperfections. Today we have a very detailed statute and many exceptions to the general rule are spelled out.

Property held for less than six months (under the older revenue acts the holding periods varied) are excluded. So also is property held primarily for sale to customers, inventories, stock in trade. Special rules are provided in certain cases relating to copyrights, literary, musical or artistic compositions. [Sec. 117 (a) (1) (C).] If land is sold with unharvested crops thereon, a special rule is provided. [Sec. 117 (j) (3).] Sales of breeding animals are specifically denied capital gain treatment in certain instances. [Sec. 117 (j) (1).] Under Section 117 (m) sales of stock in a collapsible corporation are excluded. Special rules are provided in Sec. 117 (n) for sale of securities by dealers. Under Sec. 117 (o) sales of depreciable property between spouses or between a stockholder and a controlled corporation are denied capital gain treatment. Under Sec. 115 (g) redemptions of stock essentially equivalent to dividends are taxed at normal rates. This section also denies capital gain treatment where a subsidiary acquires stock in its parent controlled by the taxpayer. This latter rule was extended in the 1954 Code to the sale of stock in one corporation to another where the selling taxpayer controls both corporations. (Sec. 304, Internal Revenue Code of 1954.)

Likewise, Congress has drawn arbitrary lines in the matter of time and of percentages. Examples of arbitrary rules in point of time are: The six months holding period to qualify property for capital gains; the one-year holding period for livestock in a breeding herd; the five-year rule under the spin-off statute; the three-year under the collapsible corporation provisions; the two-year rule on gifts in trust for charity; the 10-year Clifford rule; the three-year (formerly two-year) contemplation of death rule; and the arbitrary time rules for qualified stock options.

Some examples of tax consequences dependent upon arbitrary percentages are: The 80% control test on contributions of property for stock; the 80% rule dealing with corporate reorganizations; the 5% reversionary interest rule in the estate tax on life insurance; the 5% reversionary interest on gifts to charity; the percentage limitations on charitable deductions; the 30% rule applicable to installment sales; and the arbitrary percentage rules governing the acquisitions of stock in loss corporations by purchase or reorganization.

The foregoing are but illustrative of the many situations in which Congress, in its judgment, has made tax consequences to depend upon some arbitrary rule, either in points of time or in terms of percentage.

even to the extent of saying that poultry shall not be regarded as a capital asset, but that a heifer raised for the breeding herd shall be, provided the heifer is twelve months old (but not eleven). Such articulation leaves little room for interpretation.

Tax laws, no less than criminal laws, should be clear and certain. When the question arises whether a particular business transaction bears a 25% rate or a 91% rate, the answer should be found in the plain language of the statute, written for the man on the street, and not in some nebulous theory drawn from an alien area of the tax laws.[38] If the language is plain it should be followed, even though we may dislike the result. If an amendment is desired, Congress, not the Administrator, should make it.

Our tradition, our constitutional system, as well as the necessity for the maintenance of a respect for the law so essential to the success of our voluntary assessment system, all suggest that legislation in this sensitive area of tax rates be left to Congress. So long as Congress sees fit to extend the 25% rate to the speculator in the stock market, we must not allow ourselves to become unduly agitated over a policy that taxes sales of "mineral properties" at the same rate. If this Court's choice lies between adopting I. T. 4003 on the one hand and applying the statute as written on the other; if the choice is between taxing all oil payments irrespective of life, at 91%, and taxing short term oil payments at 25%, we respectfully suggest that it is better that

[38] As said in *U. S. v. Leslie Salt Co.*, 350 U. S. 383, 397: "The words of the statute * * * are to be taken in the sense in which they will be understood by that public in which they are to take effect."

a few taxpayers enjoy a 25% rate than it is to adopt a rule that will tax a number of years of profits at 91%. Better to follow the letter of the statute than to produce a hardship that Congress sought to avoid in Sec. 117. Better that a few taxpayers enjoy a 25% rate than that this Court should legislate.

Undoubtedly the problem here calls for legislative, not judicial action. The first problem is where to draw the line in the case of sales of mineral properties of all types. Congress, after full Committee hearing and giving due regard to the interests of both the revenue and of the industry affected, is in a better position to draw the line than is the judiciary.[39] In addition, other related problems are involved. There is the matter of inter vivos family gifts of long and short-term oil payments, which involve policy considerations different from the capital gain question. Gifts to charity involve other and different policy questions. Then there is the need to protect and prescribe the rule relating to the development oil payments. Other and different policy considerations are involved in connection with the distribution of oil payments, long and short term, by oil corporations, either as ordinary dividends or in liquidation of a stock

[39]The language of the Court in *Radovich v. National Football League, et al.*, 352 U. S. 445, 452 (1957), is applicable to this situation:

> "We, therefore, conclude that the orderly way to eliminate error or discrimination, if any there be, is by legislation and not by court decision. Congressional processes are more accommodative, affording the whole industry hearings and an opportunity to assist in the formulation of new legislation. The resulting product is therefore more likely to protect the industry and the public alike. The whole scope of congressional action would be known long in advance and effective dates for the legislation could be set in the future without the injustices of retroactivity and surprise which might follow court action."

interest. Of great importance is the treatment to be accorded the oil payments in the A. B. C. transaction. Today hundreds of millions of dollars are represented in outstanding loans secured only by such oil payments.

It is respectfully submitted that the problem of the short-lived oil payment, with all of its ramifications, be left to Congress.

3. *Alternatively, the Court should Adopt the Middle Ground,—the Insubstantial Transfer Rule.*

If the Court should feel an impelling need to deal with the problem of the short-lived oil payment, pending action by Congress, then we submit its only alternative is to adopt the Insubstantial Transfer Rule advanced by the Government as its secondary argument.

Until Congress speaks it is, of course, impossible to draw a definite line between those oil payments that are long lived and those that are short-lived—between those that clearly represent a substantial property interest within the clear intent of Congress, and those that, because of their insubstantiality, give the feeling that they are but anticipations of future income. Professor Kunz has suggested that the line should be drawn somewhere between two and five years.[40] But, obviously, the Court will draw no definite line

[40] *Kunz*, op. cit., footnote 35 supra. There he says, "The Bureau's original position in G. C. M. 24849, that an interest of one or two years duration is a short lived interest, seems reasonable enough if a *Horst* doctrine is applied. At the other extreme, a five-year payment should clearly be considered as a long-lived payment, the five-year period usually being used as a rule of thumb to calculate the return of investment in valuing royalty interests. In between two extremes, who knows how long is long?"

at any fixed number of years. This would be legislation. If an arbitrary line is to be drawn, Congress must draw it. Nor should this Court permit itself to be forced into a position, on a case by case basis, of having to draw a fixed line.

However, pending congressional action, the Court could adopt the Insubstantial Transfer Rule and leave the question of whether a particular oil payment is substantial or insubstantial to the trier of the facts, to be determined in accordance with all the facts of a particular case.

The Insubstantial Transfer Rule takes note of the unique character of oil properties as being both a mineral property and at the same time the right to future profits. If the value of the interest sold is insubstantial in relation to the value of the interest retained, or if the estimated barrels of oil required to satisfy the oil payment are insubstantial in relation to the barrels which will thereafter remain to the seller, or the estimated period of pay out of the oil payment is insubstantial in relation to the estimated life of the property, or if a combination of these and other factors exist, then it might be held by the trier of the facts that the taxpayer has not sold a mineral interest within the intent of Congress but has merely anticipated future income. If the interest sold is insubstantial, it could be reconciled with the policy stated in the *Harmel* case to the effect that the situation does not "produce the kind of hardship aimed at by the taxing act." If, however, the interest sold is substantial, it cannot be regarded as, in effect, simply an anticipation of future profits, but must

be looked upon as a sale of a substantial part of the taxpayer's investment property within the intent of the Act, as outlined in *Harmel*. This would resolve the question in each case to one of degree.

The lower courts would in each case consider all relevant factors in an effort to arrive at a fair answer. They would consider in each case, the estimated life of the oil payment. If one or two years, they would follow G. C. M. 24849 and treat it as short term; but they would not necessarily be bound by the two year rule there suggested. One of a longer life might, under the circumstances, be considered short lived. They would consider its substantiality; and its relation to the reserved interest in an effort to determine whether it is, under the facts, a sale of a substantial and durable property interest, or an insubstantial one. They would consider whether under all the facts the transaction falls within the spirit of the capital gains law; whether to tax it, under the circumstances, at normal rates would "produce the kind of hardship aimed at by the capital gains provision." They would consider whether tax motives alone caused the sale or whether business considerations were predominant. They would consider even to whom the payment was sold, since a sale to the same pipe line company that purchases the daily production might, along with other factors, indicate that it is but a prepayment of future income. They would consider, among other things, whether the taxpayer has had a real change in position as a result of the sale; and whether the sale is out of but a small

fraction of his interest, or all, or a large fraction. No single factor would be controlling; all facts would be considered, and the trier of the facts would have the duty of determining, on the facts in each individual case, whether the particular payment is long or short; whether it is substantial or insubstantial.

This approach was adopted by the Court in the gift of income area in *Harrison v. Schaffner, 312 U. S. 579 (1941)*, where it said (at p. 583):

> "Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner for all substantial and practical purposes."

This same approach was applied in the capital gains area by the Second Circuit in *McAllister v. Commissioner, 157 F. 2d 235 (1946), cert. denied, 330 U. S. 826 (1947)*. There in allowing capital gain to the sale of a life estate,[41] the Court (at p. 237) said:

> "Setting the bounds to the area of tax incidence involves the drawing of lines which may often be of an arbitrary nature. But they should not be more unreal than the circumstances necessitate. Here the line of demarcation between the *Blair* and the *Horst* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all would agree that there is some distinction between

[41]The relationship of an oil payment to relatively short-lived oil property is comparable to the relationship of a life estate to a perpetual fee.

> selling a life estate in property and anticipating income for a few years in advance. It is the kind of distinction stressed in Harrison v. Schaffner, supra. * * * *The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest.* * *" Where the line should be finally placed we need not try to anticipate here." (Italics supplied.)

This was the principle that Judge Tuttle was reaching for in the *Hawn* case, supra, where he said:

> "If, in truth, a transfer of a part of future income merely puts in the transferee a right to collect such part of the total future income *as is insubstantial either in relation to the total amounts receivable or to the time during which it will be received*, such transfer does not make it the income of the transferee for tax purposes * * * we must determine whether such transfer is for a *substantial interest* in the total property owned by the transferor. Although it might be better if Congress provided the answer, in the absence of a congressional determination, it devolves on the Court to supply it."

The adoption of the Insubstantial Transfer Rule would, in effect, give recognition to G. C. M. 24849. It would thus give the revenues the protection sought by that ruling. At the same time it would avoid the legislation involved if I. T. 4003 were adopted.

If the Court should decide to adopt the Insubstantial Transfer Rule, we submit the proper disposition of these cases would be for the Court to lay down the guiding principles to be followed by the trial Courts and to remand these cases or some of them for a determination in light of such

principles. In leaving the question of substantiality to the lower Courts, this Court would be following the precedent set in *Helvering v. Clifford, 309 U. S. 331 (1940)*, and in *Commissioner v. Culbertson, 337 U. S. 733 (1949)*.

In the *Clifford* case, the Court was asked to announce the rules for determining whether an assignment in trust resulted in the retention of substantial or insubstantial rights in the donor and the Court established rules which served to guide the trial courts in future cases. In the *Clifford* case, the Court recognized that great weight was to be given the findings of the trier of facts as to the essential issues.

Also in the *Culbertson* case, which involved the family partnership question, this Court rejected the rule which had been adopted by certain trial courts; and in pointing out the error of the trial court it enumerated various factors which should be considered in arriving at the ultimate answer of whether a bona fide partnership was created. It remanded the case for a determination in accordance with the guiding principles so laid down. With the guiding set of rules thus announced in the *Culbertson* case, the trial courts have been able to work out the family partnership cases in fairness to the Government and the taxpayers. So in these cases, we feel, should the Insubstantial Transfer Rule be adopted, the best interest of both Government and taxpayers will be served so long as there is established for the guidance of the trial Courts the rules which should govern their findings. We have enumerated above many of the facts which we think the trial Courts should take into account in making their findings. Obviously, no

single fact such as the anticipated life of the oil payment should be controlling, but all facts must be considered. As in *Clifford* and *Culbertson*, the proper disposition of these cases is to lay down the guiding principles and leave it to the trier of the facts to determine whether the particular oil payment meets the test of substantially or whether it is so insubstantial as to be an anticipation of income rather than the sale of the type of "mineral interest" that Congress had in mind in enacting the capital gain provisions.

Should the Court adopt the Insubstantial Transfer Rule, it should (1) either remand all of the pending cases with the necessary instructions to the trial Courts to enable them to decide the questions at issue; or (2) remand only certain of the cases, for as we shall hereafter show, the District Court has made the essential findings in the *O'Connor* case and the decisions below in that case should be affirmed.

Part II

The Facts and Findings in the O'Connor Case

A.

The Taxpayers in the O'Connor Case Hold a Capital Asset and are Entitled to Capital Gain Treatment.

The Executors of the Estate of Thomas O'Connor sold the oil payment in question in order to raise funds to pay the balance due on Federal estate and State inheritance taxes, in a substantial amount. All of the stock, bonds, cattle, equipment and other assets of the Estate except its land and royalties had been sold to meet these taxes but a sub-

stantial deficit still remained. The executors did not wish to borrow money to meet the deficiency; they were anxious to close the Estate, discharge their obligations and distribute the remaining properties. Accordingly in November, 1948 they sold the oil payment in question and used the proceeds to pay the balance of Federal estate taxes, State inheritance taxes and Federal income taxes. The remainder of the proceeds ($165,000) was used for ad valorem taxes and administration expenses.

The sale was of all of their royalty, under existing and any and all future leases until the amount specified had been produced, saved and sold by the purchaser. It was the only sale of an oil payment ever made by the taxpayers.

The sale was bona fide and without a scintilla of sham or subterfuge. (R. 75, 76, 77.)

The cash consideration paid to the executors by the purchaser amounted to approximately $10,000,000. The basis of the oil payment in the executors' hands was approximately $2,000,000. The gain on the sale was approximately $8,000,000, and on this, at the capital gain rates of 25%, the taxpayers acknowledge a capital gains tax of approximately $2,000,000. The Government seeks an additional $3,600,000.

Considering the purpose for which the oil payment was sold,—to pay the balance of some $17,000,000 in death duties,—the taxpayers naturally feel rather strongly that the Government should be content with the $2,000,000 capital gains tax on this sale, and should not insist on an addi-

tional $3,600,000 unless the statute clearly requires such additional tax.

As indicated above, the statute does not clearly so provide. It allows capital gain on the sale of a "mineral property." The taxpayers sold a "mineral property." They sold, by a deed, duly acknowledged and recorded, all of their royalty, under existing and any and all future leases, until the amount specified in the deed had been produced, saved and sold by the purchaser. Thereafter, the buyer owned all of the royalty, produced it and sold the production, reported his income from the property, and paid tax on this income, less his cost depletion.

If this Court should adopt I. T. 4003 (the Government's primary contention) and hold that the sale of all carved out oil payments irrespective of life are normal income, then the decision below must be reversed. If the Court should accept our primary contention that the statute should be followed as written, leaving amendments to Congress, then the taxpayers win and the decisions below should be affirmed.

If, however, the Court should adopt the Insubstantial Transfer Rule (which is the Government's as well as our alternative position), then these taxpayers still win. Whatever remand is made of the other pending cases, the lower court has made all of the essential findings necessary to bring this case within the Insubstantial Transfer Rule, and remand in the *O'Connor* case is not called for. The *O'Connor* case was tried and decided on the basis that the Insubstantial Transfer Rule might possibly be the correct rule.

1. The sale was made in 1949. At that time G. C. M. 24849, supra, was in effect. It will be recalled that that G. C. M. reached "short-lived," as distinguished from "long-lived" oil payments, e. g., those referred to in the ruling that normally "pay out in one or two years." I. T. 4003, supra, extending the policy to all carved out oil payments, irrespective of life, was not promulgated until 1950, after the sale in question was made.

Judge Rice, the District Judge, specifically found (R. 77) "The property so sold was a long-lived, and not a short-lived, oil payment."[42] Thus, as the Court found, the sale satisfied all of the requirements of the Treasury rules in force when the sale was made. The Government does not challenge this determination of the Trial Court which was affirmed on appeal. Its contention is that its own ruling, in effect when the sale was made, was wrong; and despite full compliance with that ruling, its position now is that this sale should now be governed by a later ruling (I. T. 4003), representing a change in policy, which is given retroactive application.[43]

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[42]The oil payment paid out in three years of production, during which the properties were owned by Blackburn. The Court also found:

> "The oil payments would have taken an appreciably longer period to pay out had it not been for the fact that there was an increase in the production in the field by the operating lessees and had it not been for the further fact that there had been a substantial increase in the price of oil shortly prior to the sale, which higher price was maintained during the period of pay-out." (R. 76.)

[43]Since G. C. M. 24849 represents a change in policy, it was expressly made prospective only in its application, not applying to oil payment assignments made prior to April 1, 1946. I. T. 3895, 1948-1 Cum. Bull. 39. However, when the Treasury in 1950 shifted to the extreme position taken in I. T. 4003, no comparable provision for prospective application was published and that ruling is here being applied retroactively.

This phase of the Government's case is especially open to criticism. The Courts stand ready to protect taxpayers against retroactive legislation. Can they not protect taxpayers against retroactive administrative rulings, particularly where, as here, the ruling is itself open to a very serious question as to its constitutionality and validity? At the very least, we have here a very serious violation of principles of sound tax administration,—the observance of the rules of fair play,— which is so necessary to the maintenance of respect for the law and its administration.

In any event, if the Insubstantial Transfer Rule is adopted, the question of whether the carved out oil payment is long or short is an important factor and on this the trier of the facts has found that the oil payment in question is long-lived and not short-lived.

2. The District Court also found (R. 76):

> "The royalty interest (or oil payment) sold to Blackburn represented a substantial part of the plaintiffs' oil in place. Also, in terms of the relative values of the interest sold and of the reversionary interest retained by the sellers, the transfer represented a substantial part of the sellers' royalty interest."[44]

[44] The District Court's finding that the transfer represented a "substantial part of the sellers' royalty interest" is certainly justified by the facts—approximately 4,000,000 barrels of oil in place (R. 50) were sold at a price of about $10,000,000 (R. 48). The oil sold had a tax basis of $2,000,000 (R. 49), and a profit of $8,000,000 was realized. Oil in place is commonly valued at $1 per barrel, and so valued, the sellers' oil was worth approximately $23,000,000; thus in terms of value sellers sold nearly 50% of their oil. Considering the fact that salt water was encroaching on the field and that production was declining (R. 64), it is clear that taxpayers sold the cream of their properties. All of the foregoing figures clearly indicate that the oil in place sold was substantial, in terms of what the sellers owned, in terms of what the sellers retained, and in absolute terms.

Also the Court found: (R. 77)

> "The transaction was not intended to be and was not, as a matter of fact or as a matter of law, an assignment of income, but was the sale of a property interest to Blackburn, which property interest produced income in the hands of Blackburn. This property interest was substantial and real, representing a substantial part of the grantors' royalty interest."

In light of these findings, it is submitted that the District Court has made all of the essential findings necessary to bring this case within the Insubstantial Transfer Rule, should this Court decide to adopt that rule.

As we have earlier pointed out, the question of insubstantiality should be left to the trier of the facts. It has long been the view of this Court that conclusions of this type, involving opinions on the matter of degree, are for the trier of the facts.

As stated by this Court in *Bingham v. Commissioner, 325 U. S. 365, 370 (1945)*:

> "Ordinarily questions of reasonableness and proximity are for the trier of fact. * * * And even when they are hybrid questions of 'mixed law and fact', their resolution, because of the fact element involved, will usually afford little concrete guidance for future cases, and reviewing courts will set aside decisions of the Tax Court only when they announce a rule of general applicability, that the facts found fall short of meeting statutory requirements * * *."

The question of "insubstantiality" like questions of "reasonableness and proximity", should likewise be left to the triers of fact since they will usually afford little concrete

guidance for the courts in future cases; they do not involve "a clear cut question of law"; and do not involve "a rule of general applicability." See, *Commissioner v. Bedford, 325 U. S. 283 (1945).*

In *Graver Manufacturing Co., Inc. v. Linde Products Co., 339 U. S. 605, 609-610 (1950)*, this Court, in a patent infringement suit, held that:

> "What constitutes *equivalency* must be determined against the context of the patent, the prior art, and the particular circumstances of the case * * *.
>
> "A finding of equivalence is a determination of fact. * * * It is to be decided by the trial court and that court's decision, under general principles of appellate review, should not be disturbed unless clearly erroneous * * *." (Emphasis added.)

A finding of substantiality is, like a finding of equivalency or reasonableness, or of proximity, a question principally of fact and degree, and should be left to the lower courts. The question here is not whether this Court, sitting as a trier of the facts, might not have reached a different conclusion; it will sustain the lower courts unless clearly erroneous.

3. The District Court also found (R. 77):

> "The transaction was not intended to be and was not, as a matter of fact or a matter of law, an assignment of income. * * *
>
> "The property interest so sold to Blackburn was a capital asset as defined in Section 117 of the Internal Revenue Code of 1939, and this capital asset had been held by plaintiffs for more than six months.

> "None of the exceptions in Section 117 *or elsewhere in the Internal Revenue Code*, denying a transaction long term capital gain treatment, are applicable to the instant transaction."

The ultimate findings are entitled to finality here. Here we should quote the Government's own position taken from its reply brief in this Court in *Morris W. Zack v. Commissioner, No. 217, October Term 1957 (cert. denied, Oct. 14, 1957)*:

> "Whether particular property falls within the excepted category (property held by the taxpayer for sale to customers, etc.) presents a question of fact in each case, no single evidentiary factor being decisive, and the trial court's conclusion is entitled to affirmance unless clearly erroneous."

and

> "Both Courts below decided the factual issue against the taxpayer; their concurrent finding is entitled to finality here. *Corn Products Co. v. Commissioner*, 350 U. S. 46, 51; *Comstock v. Group of Investors*, 335 U. S. 211, 214."

And as this Court said in the *Corn Products* case, cited above:

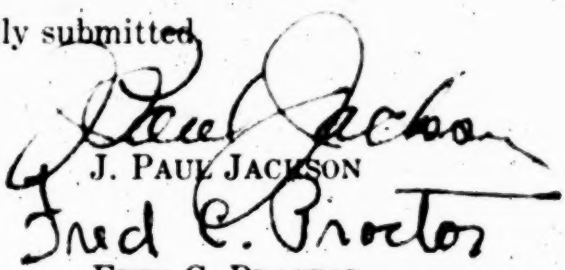
> "On essentially factual questions, the findings of two Courts should not ordinarily be disturbed."

CONCLUSION

It is respectfully submitted that this Court should leave the problem of the short-lived oil payment to Congress, in which event decision below in this case should be affirmed. Alternatively, the Court should adopt the Insubstantial Transfer Rule in which case the essential findings on sub-

stantiality have been determined by the two Courts below. Accordingly, this case should be affirmed even though the other cases now before the Court are remanded for findings on the question of substantiality.

Respectfully submitted,



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APPENDIX A

Statutes Involved

Internal Revenue Code of 1939

"SEC. 117. CAPITAL GAINS AND LOSSES.

[Sec. 117 (a)]

"(a) Definitions.—As used in this chapter—

"(1) Capital Assets.—The term 'capital assets' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) Stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) Property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

(C) A copyright; a literary, musical, or artistic composition; or similar property; held by—

"(i) A taxpayer whose personal efforts created such property, or

"(ii) A taxpayer in whose hands the basis of such property is determined for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or * * *

"* * *

"(4) Long-Term Capital Gain.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

[Sec. 117 (c)]

"* * * (1) * * * (2) * * *

"(B) There shall then be ascertained an amount equal to 25 per centum of the excess of the net long-term capital gain over the net short-term capital loss. In the case of any taxable year beginning after October 31, 1951, and before November 1, 1953, there shall be ascertained, in lieu of the amount computed under the preceding sentence, an amount equal to 26 per centum of the excess of the net long-term capital gain over the net short-term capital loss.

[Sec. 117 (f)]

"(f) Retirement of Bonds, Etc.—" * * *

[Sec. 117 (g)]

"(g) Gains and Losses from Short Sales, Etc.—" * * *.

[Sec. 117 (j)]

"(j) Gains and Losses From Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.—

"(1) Definition of Property Used in the Trade or Business.—For the purposes of this subsection, the term 'property used in the trade or business' which means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory

of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in subsection (a)(1)(C). Such term also includes timber or coal with respect to which subsection (k)(1) or (2) is applicable and unharvested crops to which paragraph (3) is applicable. Such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition. Such term does not include poultry.

(2) General Rule.—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets.

* * * * *

"(3) Sale of Land With Unharvested Crop.—In the case of an unharvested crop on land used in the trade or business and held for more than 6 months, if the crop and the land are sold or exchanged [or compulsorily or involuntarily converted as described in paragraph (2)] at the same

time and to the same person, the crop shall be considered as 'property used in the trade or business.'."

[Sec. 117 (k)]

"(k) Gain or loss in the Case of Timber or Coal.—"

[Sec. 117 (l)]

"(l) Short Sales, Etc.—" • • •.

[Sec. 117 (m)]

"(m) Collapsible Corporations—"

"(1) Treatment of Gain to Shareholders.—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset."

• • •.

[Sec. 117 (n)]

"(n) Dealers in Securities.—"

[Sec. 117 (o)]

"(o) Gain From Sale of Certain Property Between Spouses or Between an Individual and a Controlled Corporation—

"(1) Treatment of Gain as Ordinary Income.—In the case of a sale or exchange, directly or indirectly, of property described in paragraph (2)—

(A) Between a husband and wife; or

(B) Between an individual and a corporation more than 80 per centum in value of the outstanding stock of which is owned by such individual,

his spouse, and his minor children and minor grandchildren;

any gain recognized to the transferor from the sale or exchange of such property shall be considered as gain from the sale or exchange of property which is neither a capital asset nor property described in subsection (j).

"(2) Subsection Applicable Only to Sales or Exchanges of Depreciable Property.—This subsection shall apply only in the case of a sale or exchange of property by a transferor which in the hands of the transferee is property of a character which is subject to the allowance for depreciation provided in section 23 (l)."

APPENDIX B

Tax Treatment of Various Oil and Gas Interests

I. *Lease*

An oil and gas lease is not a lease in the usual sense of the word. Under Texas law and under the laws of most oil producing states, it represents a horizontal severence of the minerals in place and a conveyance of seven-eighths (7/8) or other fraction thereof to the lessee by way of a determinable fee. The owner of the lease, whether he be the original lessee or an assignee of the lessee, is said to own the working interest or operating rights. This working interest carries with it the right, as well as the burden, of developing and operating the lease in question. The owner's interest in the lease and in the oil thereunder is real property. It is subject to all of the state laws relating to real property. The oil in the ground is an interest in realty and becomes personalty when it reaches the surface. Daily production of oil is ordinary income subject to the depletion allowance. However, the sale of the lease (or a fractional interest therein) is the sale of "property held for productive use in trade or business" and is entitled to capital gain treatment under Section 117 (j) of the 1939 Code, unless the taxpayer is a dealer in leases and the leases are held primarily for sale to customers in the ordinary course of his trade or business. *I. T. 3693, 1944. Cum. Bull. 272; Vern W. Bailey, 21 T. C. 678, 684, (1954); Walter A. Henshaw, 23 T. C. 176, 180 (1955).* The exchange of a

producing oil lease, held for productive use in trade or business or for investment, for fee interest in improved ranch to be held for productive use or investment, constitutes a tax-free exchange of property of like kind. *I. T. 4093, 1952-2 Cum. Bull. 130.*

II. *Bonus*

The bonus is the cash consideration paid by the lessee to the lessor for the determinable fee. It is purchase money under local law but is treated as advance royalty for income tax purposes. *Murphy Oil Co. v. Burnet, 287 U. S. 299 (1932).* As an advance royalty, the bonus is ordinary income to the lessor subject to the statutory depletion allowance. However, to the lessee, the bonus paid represents cost to the lessee and must be capitalized. The bonus may be paid in a lump sum or the lessee may pay the same in installments, in which event the lessor takes into income the payments when and as received by him. *Kleberg, 43 B. T. A. 277 (1941).* It has been held that if a lessor sells to a third party his right to receive future bonus payments, he has sold an advance royalty and is entitled to capital gain treatment on such sale. *Kleberg, 2 T. C. 1024 (1943); Cowden, 9 T. C. M. 1148 (1950).*

III. *Royalty*

Unlike the royalty customarily encountered in hardrock mineral leases, the oil and gas royalty is the retained ownership of the one-eighth (1/8) (or larger) interest in the oil or gas in place. The oil and gas in place is real property;

when it reaches the surface, it becomes personalty. The royalty owner owns the oil when it reaches the surface and sells it to a purchasing pipeline company. The pipeline company is an independent corporation or other organization, frequently a subsidiary of a major integrated oil company. The pipeline company purchases the oil at the wellhead and transports the oil to a refinery or other marketing outlet. Payment is made monthly to the seller of the oil, whether he be an operator, a royalty owner or other owner of oil in place. Since the oil in place is real property, the pipeline company's attorneys must examine the deed records of the county in order to be sure their company is remitting to the true record owner of the mineral estate.

Since the royalty interest is real property, it is governed by the laws of descent and distribution, by the laws of conveyance and recordation dealing with real property, and by the state ad valorem taxes affecting real property. For income tax purposes, the royalty interest is an economic interest in oil in place. Daily production is subject to normal tax treatment under *Burnet v. Harmel, 287 U. S. 103 (1932)*, subject to the depletion allowance. However, the royalty interest itself is a capital asset so that the sale of an entire royalty (or an undivided interest therein) is the sale of "property" and subject to capital gain treatment under Section 117 (a) of the 1939 Code. G. C. M. 12118, XII-Cum. Bull. 119 (1933), Rev. Ruling 55-526, 1955-2 Cum. Bull. 574; J. E. Murphy, 9 B. T. A. 610 (1927). The only instance in which capital gain is not allowed is where

the taxpayer is a dealer, buying and selling royalties, and is holding the property primarily for resale to customers in the ordinary course of such business. See *Darby Lynde Co. v. Alexander, 51 F. 2d 56 (10th Cir. 1931); Commissioner v. Fleming, 82 F. 2d 324 (5th Cir. 1936); Anna Taylor, 3 B. T. A. 1201 (1925); J. M. Hudson, 14 B. T. A. 983 (1928); R. R. Ratliff v. Commissioner, 36 B. T. A. 762 (1937); Greene v. Commissioner, 141 F. 2d 645 (5th Cir., 1944); P. A. Davis, 11 T. C. M. 704 (1952); J. E. Thompson, 7 T. C. M. 612 (1948).*

IV. *Overriding Royalty*

An overriding royalty is an additional royalty over and above the landowner's usual 1/8 royalty. The overriding royalty is usually created where a lessee or other owner of a lease "farms out" or assigns the lease to an assignee, retaining an additional fraction of the oil, if, as and when produced, as an overriding royalty, free and clear of all development and production expense. The overriding royalty is in all respects the same as the usual royalty; it is real property; an economic interest in oil in place; the receipts therefrom are normal income subject to depletion. However, a sale of an overriding royalty (or a fraction thereof) would be a sale of "property" and therefore the sale of a capital asset.

V. *Oil Payments*

An oil payment is often referred to as a "production payment" and more frequently referred to as a "limited overriding royalty." It is like a royalty in all respects ex-

cept that it is limited either to a specific number of barrels of oil in place or is measured by a specified sum of money. In the majority of cases, the oil or production payment is limited by a certain specified dollar amount. However, except for the limitation either in barrels or dollars, it is in all respects the same as a royalty. It is a specie of real property representing the ownership of a certain specified or ascertainable amount of oil in place; it is real property under the laws of Texas and most of the other states and subject to all of the state laws governing the devolution of real property at death, to the state recordation statutes relating to real property and to the state ad valorem taxes relating to real property. *Tennant v. Dunn, et al., 110 S. W. 2d 53 (Tex. Comm. of App. 1937); State v. Quintana Petroleum Co., 133 S. W. 2d 112 (opinion adopted by the Texas Supreme Court, 134 S. W. 2d 1016 (1940); State v. Whittenberg, 265 S. W. 2d 569 (1954).* It represents an economic interest in oil in place and consequently payments made to the owner with respect to the production attributable thereto is ordinary income subject, however, to the depletion allowance. *Thomas v. Perkins, 301 U. S. 655 (1937).* While all of it is income if held by the owner until extinction, a sale thereof in its entirety or of a fractional interest therein entitles the seller to capital gain treatment. G. C. M. 24849, 1946-1 Cum. Bull. 66; I. T. 4003, 1950-1 Cum. Bull. 10.

For a general description of various kinds of oil payments, see Trevathan, Federal Aspects of Oil Production Payments, 35 Taxes, The Tax Magazine, 179 (1957).

VI. *Reserved Oil Payment*

Customarily, in farming out an oil property, or in selling or assigning the same, the seller will retain an oil payment. See, *Thomas v. Perkins*, supra. Such a reservation, like the reservation of a royalty or an overriding royalty, is a reservation of a property interest or economic interest in oil in place. The income therefrom is the income of the holder of the reserved oil payment on which he is entitled to depletion. A subsequent sale of such reserved oil payment, in whole or in part, entitles the seller to capital gain treatment.

VII. *Development Oil Payment*

Oil payments are frequently given to a contractor as consideration or part consideration for the drilling of a well. It may be given to supply houses for the equipping of wells or to geologists or petroleum engineers, landmen, lawyers and others, to assist in the search for oil or in the development of oil properties. When so given, they are known as development oil payments. In such cases, no gain or loss is recognized on the exchange of the oil payment for the services of the geologists, or in exchange for a well, or in exchange for equipment on the well. The contractor or supply house receiving such an oil payment will capitalize the cost of the well or the cost of the equipment as the cost of the oil payment and obtain a recovery of such costs over the life of the oil payment through cost depletion or statutory depletion, whichever is greater. Similiarly, if an oil payment is sold and the proceeds thereof are ear-

marked or pledged for the development of oil properties, the oil payment is regarded as a development oil payment; and the sale is not recognized as a taxable transaction. The seller is not required to account as income for the cash so received which is pledged for development. *G. C. M. 22730, 1941-1 Cum. Bull. 214; I. T. 4003, 1950-1 Cum. Bull. 10; G. C. M. 24849, 1946-1 Cum. Bull. 66; Rawco, Inc., Ltd., 37 B. T. A. 128 (1938); Trans-California Oil Company, Ltd., 37 B. T. A. 119 (1938); Vern W. Bailey, 21 T. C. 678 (1954).* If; however, an obligation to the drilling contractor or to a supply house is created prior to the creation of the oil payment, and the oil payment is given in satisfaction of such fixed obligation, then the obligation will be considered to have been discharged by the granting of the oil payment; the taxpayer will be considered to have disposed of an asset in satisfaction of an obligation, thereby realizing taxable gain. If the purchaser, contractor, supply house or other person has acquired a development oil payment and holds the same to extinction, all of it would be income in such owner's hands, subject to normal taxation and subject, however, to percentage or cost depletion. But if such owner were to sell the oil payment or sell a fractional interest therein, he would be entitled to capital gain treatment.

VIII. *Guaranteed Oil Payment*

If one grants a development or other type of oil payment and guarantees to the holder thereof that the oil payment will pay out, then he has created an obligation, which

obligation is satisfied as the oil payment pays out. Under such circumstances, the obligor is taxable on the income from the oil payment in the hands of the obligee. *C. F. Anderson v. Helvering, 310 U. S. 404 (1940); Delacroix Corporation, 13 T. C. 827; 839 (1949); Charles Burke, 5 T. C. 1167 (1945); Refiners Production Co., 43 B. T. A. 481, 494 (1941).*

IX. *Carved Out Oil Payment*

An oil payment is said to be "carved out" when it is created from a larger oil interest. It may be carved out of a royalty interest or a leasehold or working interest or out of a larger oil payment. It may be "carved out" and retained on a farmout transaction or "carved out" and given as a development oil payment. When a carved oil payment is sold for cash or other valuable consideration, the purchaser has, as his cost, the consideration paid therefor; he has an economic interest in oil in place; and his income with respect to the oil payment is ordinary income; and upon sale he is entitled to capital gain. However, the Government's present position is that the seller of a carved out oil payment (other than a development oil payment) has sold income and is denied capital gain treatment.

X. *Interest-Bearing Oil Payment*

As stated above, the oil payment is limited either by a specified amount in dollars or by a specified number of barrels of oil. More frequently, it is measured by a dollar

limitation. With the increasing use of development oil payments and with the increasing popularity of the A-B-C transaction hereinafter described, the interest-bearing oil payment has attained widespread use. The interest factor in an interest-bearing oil payment is not interest in any true sense; it is simply a measuring stick to determine the additional quantity of oil in place represented by the oil payment. The interest-bearing oil payment gives to the holder thereof the ownership of an economic interest of a quantity of oil in place measured by the face amount specified in the payment, together with an additional amount equal to what would be interest on such face amount calculated on declining balances. Typically, also, the oil payment will specify that the holder will own, free of lifting and development costs, a quantity of oil which will produce to the holder, free of cost, an additional amount equal to any ad valorem tax or gross production tax attributable to such oil payment. Here again, like the interest factor, the provision giving to the holder an amount equal to ad valorem and production taxes is but a yardstick to determine the extent of the holder's interest in oil in place.

XI. *The A-B-C Transaction*

The A-B-C transaction involves the use of oil payments in connection with the sale of productive property. While these transactions vary in detail, the following example will illustrate the typical type of A-B-C deal. A, the owner of a producing lease, desires to sell the same for $1,000,000.

He enters into a three-way transaction with B and C. He sells the working interest or lease to B for $500,000 in cash and retains or reserves an oil payment payable out of 80% of the production in the face amount of $500,000, bearing interest on declining balances at 6% per annum. Simultaneously, or immediately thereafter, he sells his retained oil payment to C for $500,000 in cash. C borrows $500,000 from the bank, putting up the $500,000 oil payment as collateral, and the bank charges him 5% interest. In this transaction, A, the seller, has sold all of the property he owns in two transactions: (1) the working interest to B, burdened with an oil payment, for $500,000; and (2) the oil payment to C for $500,000, thus realizing the $1,000,000 asking price. On this transaction, A obtains capital gain treatment. B, who has acquired the working interest, acquires the same burdened with the oil payment, and B is not taxed on the 80% of production going to C, to retire the oil payment. B pays tax during the payout of the oil payment only on the 20% of the production, against which he may expense his lifting and development costs. C is taxable at ordinary rates on the income from the $500,000 oil payment, but since he has a $500,000 cost, his taxable income is simply the difference between the 6% interest factor in the oil payment and the 5% interest that he pays to the bank.

Most sales of producing properties today are made by and through the means of the A-B-C transaction above described, or some variation thereof. If the transaction is

bona fide and there are no guarantees of the oil payment by either A or B, the transaction will be recognized by the Treasury Department and the tax results described above will be recognized. Neither A nor B will be deemed to have sold a carved out oil payment and neither of them will be deemed to have assigned or sold income to C, the purchaser of the oil payment.

Many rulings have been granted on these transactions and these transactions are recognized by the Treasury for tax purposes.

On the use of the A-B-C transaction, see Welsch, Acquiring Oil Properties Through Oil Payments and Related Methods, 32 Taxes, The Tax Magazine 494 (1954).

XII. *The Carried Interest*

The carried interest involves a specie of oil payment. Typically, the transaction would be as follows: A is the owner of a producing oil property; he desires the property to be further developed but does not have the funds to drill the additional necessary wells. B is willing to develop the property and to allow A to retain an interest. A thereupon assigns the lease to B, absolutely and in its entirety. B commits himself to drill the necessary development wells at his sole cost and expense. B pays to A $100,000 in cash for the proven lease and, in addition, agrees that after he, the assignee, has from 100% of the production obtained a recovery of his $100,000, plus an amount equal to all costs of development, plus an amount equal to all costs of operat-

ing, that thereupon a one-half (½) interest in the lease will revert to A. In this type of carried interest or carried working interest, A is being carried for a half interest. The tax consequences are that during the payout period, B who is the pro tem owner of the lease, is entitled to all of the income and will be taxed on all of the income from the property subject to the depletion allowance; B as the pro tem owner of the working interest, would be entitled to charge off all the intangibles incurred in the drilling of the wells and would likewise be entitled to deduct all of the operating expenses as well as the depreciation on the equipment installed in the wells. Since A has only a reversionary interest, he is not taxed during the payout period nor does he get the benefit of the intangibles or other deductions. After the payout, the parties are 50 50 owners of the property and thereafter share annually the income, deductions and expenses. A is not taxed on the value of the interest when it reverts since he has owned that interest throughout.

Despite the fact that A has sold the property subject to a reversionary interest in himself, he is nevertheless deemed to have sold a capital asset and consequently will have the benefit of capital gain treatment on the $100,000 of cash paid to him by B on the assignment of the lease. The existence of the reversionary interest in A does not deprive him of his capital gain treatment under current Treasury practice.